No. 15752

# United States Court of Appeals
## FOR THE NINTH CIRCUIT

MATHEW J. SPIESMAN, JR., and
MARY SPIESMAN, *Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

*Appeal from the Tax Court of the United States*

## REPLY BRIEF FOR PETITIONERS

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### INTRODUCTION

The Petitioners' main brief in this proceeding was filed with the Court on or about the 22nd day of January, 1958. The Respondent's brief was filed on or about the 5th day of March, 1958, pursuant to a stipulation agreed to between counsel for the parties. The Petitioners were served with the Respondent's brief on or about the 6th day of March, 1958. The Petitioners' reply brief is due on or before the 7th day of April, 1958.

## PETITIONERS' REPLY TO RESPONDENT'S ARGUMENT

The Petitioner in his main brief has set out in detail the reasons why this Court should reverse the Tax Court of the United States in *Spiesman et ux vs. Commissioner* (1957), 28 TC 567. The Respondent in his brief asserts that the Tax Court of the United States properly decided the case and as a basis cites the following reasons:

1. That Section 340 of the Revenue Act of 1951 merely eliminated from the troublesome family partnership area the question of a partnership interest acquired by gift (Respondent's argument number 1, Respondent's brief, page 17).

2. That the Tax Court of the United States correctly applied the 1951 Revenue Act amending the family partnership law to the facts in the instant case and arrived at the proper conclusion that the five minor children of Petitioners did not receive their interest in the partnership by a bona fide gift and that the partnership was a sham (Respondent's argument number 2, Respondent's brief, page 22).

3. That the facts of record show conclusively that the Tax Court should be affirmed (Respondent's argument number 3, Respondent's brief, page 24).

All the arguments set forth in Respondent's brief are fully covered in Petitioners' main brief and the assignments of error thereunder, but a few comments are in order.

In analyzing the changes made by Congress by the Internal Revenue Act of 1951 (see Section 340, Internal Revenue Act of 1951) regarding partnerships, Respondent cites the same Committee Reports relied upon by the Petitioners in their main brief. Basically, the touchstone of the Congressional intent is set forth in the Committee Reports set out at page 20 of the Respondent's brief and at page 17 of the Petitioners' main brief. Specifically, it is stated that the Commissioner is still free to inquire into the validity of the family partnership in cases where the formation of the partnership by gift is a mere *sham*. As Petitioners have pointed out in their main brief, the word *sham* is to be accorded its real meaning. (See Petitioners' main brief pages 22 and 23). There is no *sham* present in the instant case.

As previously pointed out, Congress when the word *sham* was used necessarily had in mind a situation where a family partnership was utilized to minimize taxes and where the parent used the money allocated to the children for his own use. This position is recognized in the Committee Reports referred to in the Tax Court opinion (R. pps. 178, 179) wherein the following is quoted from the said Committee Reports:

> "Not every restriction upon the complete and unfettered control by the donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner

> or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit."

Petitioners in their main brief have set forth in detail the reasons why the partnership involved herein was not a sham. It would be repetitious to repeat those reasons.

The Respondent in his main brief takes the view that the 1951 amendment to the law regarding the taxation of partnerships (Section 340 of the Revenue Act of 1951) only eliminated from consideration in family partnership cases one factor, i.e., that a valid family partnership could arise from a bona fide gift (Respondent's brief, page 22). The Respondent then asserts that giving full effect to this change the Tax Court of the United States correctly found in the instant case "that there were no bona fide gifts of interest in the machines which were the income-producing assets of the partnership, to the children, and the formation of Spiesman & Sons partnership was a sham." (Respondent's brief, page 23).

The Petitioners in their main brief have fully covered this argument. In attempting to substantiate the finding of *sham*, the Respondent's brief points to certain factors which although fully covered in Peti-

tioners' main brief bear additional mention. The Respondent states that several factors point to the correctness of the Tax Court's findings. First, it is asserted that the partnership agreement was not carried out in the important respect of the distribution of profits (Respondent's brief, page 24).

This argument confuses the basic distinction between withdrawals from a partnership and partnership distributable income. It is the latter which is important, not the former. The record amply illustrates that the partnership allocated the distributable partnership income in accordance with the partnership agreement to Petitioner, Mathew J. Spiesman, his father and Petitioners' five minor children during the taxable years involved herein. The record further discloses that the children of Petitioners filed income tax returns based on each child's proportionate share of partnership distributable income. It does not matter that each child did not withdraw his proportionate share. The important factor is that each child could have withdrawn his distributable share of partnership income. This Court has recognized the basic distinction, as pointed out above, between withdrawals and partnership distributable income. In *William P. Neil et. ux. vs. U. S.* (CA, 9-1935) 205 F. (2d) 121, this Court said:

> "It is immaterial, if true, that only $19,456.39 of William P. Neil's distributive share of the partnership's ordinary income for 1946, computed as provided in Section 183(b), was distributed to him; for, in computing their net incomes for

1946, appellants were required to include all of that share whether distributed or not."

The Respondent's brief in commenting upon the argument that there were unequal withdrawals cites at page 25 of Respondent's brief the excerpts from the record containing Petitioners' explanation of why unequal withdrawals were made. It should be noted that the Petitioner following the quoted testimony above testified further as follows:

> "Q. Did you subsequently make an adjustment, in a subsequent year, on your accounting?
>
> "A. I did, on this, in 1954. I think an adjustment is made, I am sure, I know it is, and the money that was withdrawn from, I mean the money that was held out of Joe and Phillip was credited to the three youngest boys, was returned to Joe and Phillip, the oldest boys.
>
> "Q. This money was in the bank, or cash on hand, so that you had no trouble making the change back, of the money that had been expended?
>
> "A. Yes; it is in the safe deposit books, records." (R. pps. 90, 91.)

The Petitioner, after he found out that he shouldn't have withdrawn an unequal amount in an attempt to equalize the balance of the children's accounts, did transfer the money back as he testified (see Exhibits J, K, L, M, and N). It must certainly be noted that the appropriate Probate Court sanctioned the action of Petitioner in every regard. Certainly if there was any impropriety in the actions of the Petitioner, the

Probate Court would not have acquiesced in the Petitioners' accounting.

The Respondent next asserts that the partnership agreement is an inconclusive instrument of conveyance and that this factor is therefore indicative of the Tax Court's finding that no bona fide gifts were made (Respondent's brief, page 26). Does this mean that the Respondent is asserting that there can be no bona fide gift of a partnership interest without a written conveyance? Certainly the basic common law elements of gift are here present, i.e., intent, delivery and acceptance. There is no requisite to be found anywhere in the tax law indicating that a partnership cannot be formed without a conveyance by instrument. And this would apply equally well to a conveyance of assets prior to the formation of a partnership or the gift of a partnership interest. See, for example, *William Weizer v. Commissioner* (CA, 6-1948), 165 F. (2d) 772, wherein an oral partnership was recognized as valid for tax purposes. The conveyance of a partnership interest or the assets of the partnership can be made orally for tax purposes. Certainly this would negate any assertion that a partnership cannot be bona fide or valid where there is no formal instrument of conveying either the partnership interest or the assets in the partnership to the donee. In any event, the partnership agreement itself can certainly operate as an instrument of conveyance for federal tax purposes.

The Respondent next mentions the Petitioners failure to file accountings as guardian for the children until after the Internal Revenue Service investigation was initiated (Respondent's brief, page 26). This argument by Respondent is answered fully in Petitioners' main brief at page 32 under the Argument on Assignment of Error III(a). However, it bears repeating that although late, the guardianship accountings were approved in every way by the Probate Court in and for Benewah County, Idaho (Exhibit 13). The most important factor is that the children received all of the money and that the State Probate Court fully recognized that.

The Respondent next alludes to the fact that the capital account of the partners on the partnership returns as filed, listed the machines as being owned by the Petitioner (Respondent's brief, page 26). The answer to this argument is fully set forth in Petitioners' main brief at page 27, Assignment of Error II(b). It should be noted that the depreciation on the said machines was distributed equally to the individual partners in computing their distributable share of partnership income. This factor, of course, should certainly bear upon the question of who owned the machines.

The Respondent next asserts that the interlineations on the partnership agreement show that there was no real gift (Respondent's brief, pages 26 and 27). The Petitioners in their main brief have set forth their position on the interlineations (Petition-

ers' brief, pages 24 and 25, Assignment of Error II(a) ). The uncontroverted facts of record show conclusively that Petitioner's father owned a one-half interest in the machines prior to the transfer of the assets to the Spiesman & Sons partnership (Exhibit 9). This illustrates the reason for the interlineations on the partnership agreement. The testimony of Petitioner and his father is uncontroverted in this respect. The fact that the partnership did save tax is completely immaterial. The Respondent cites Regulations 111, Section 29.191-1(b)(10) as authority for his position on the tax-saving aspects of the partnership (see Respondent's brief, footnote 4, page 27). The Tax Court of the United States pointed out in its opinion (Transcript 180) that the regulations relied upon by the Respondent were not promulgated until August 18, 1953, and therefore have no applicability to the instant case.

The last reason set forth by Respondent for upholding the decision of the Tax Court is based upon an interpretation of the Idaho law which provided that no person other than a licensee can own any interest in slot machines (Respondent's brief, pages 27 and 28). The Petitioners' answer to this argument is set forth in Petitioners' main brief, pages 34 and 35 under the Assignment of Error III(b). Specifically, the Idaho law relied upon by the Tax Court and the Respondent is in direct conflict with the Federal law and the Federal law for tax purposes must therefore control. In any event, the state law is not determi-

native of the question of validity of family partnership. Aside from these reasons, however, the minor children of Petitioner did not have to have an interest in the assets of the partnership to be a valid partner since they had an interest in the partnership which is perfectly permissible under Idaho law.

Idaho enacted the uniform partnership act effective as of January 1, 1920. Section 53-326 of the Idaho Code is entitled "Nature of Partner's Interest in Partnership" and provides as follows:

> "A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property."

This section of the Idaho law corresponds to Section 26 of the old Uniform Partnership Act. Section 53-326 above, contains no annotated cases on point but the annotations refer to Volume 68 of *Corpus Juris Secundum,* Section 85 under *Partnerships,* which provides in part as follows:

> "Although title to it [firm assets] is held or taken in the name of one of the partners, the rule is that the partners do not, as individuals, own the firm property, but that it is held by, and belongs to, the partnership as such, and the partners do not as individuals, have any specific interest in any particular asset or particular part of the assets; nor can a partner assign or transfer an undivided share in any specific articles belonging to the partnership. The interest has been said to be a mere chose in action. It is property, or, more precisely, personal property . . ."

The Petitioners' minor children in the instant case owned a share in the partnership (i.e., a partnership interest). There is no question that a minor is capable of owning a partnership interest under Idaho law. The Idaho law concerning the ownership of the machines is nondeterminative on the question presented in this appeal.

In Petitioners' main brief, it was asserted that the Tax Court of the United States had erred in not allocating a portion of the income back to Petitioner's father (Assignment of Error IV, Petitioners' main brief, page 41). The Respondent in footnote 7 of his main brief, page 27, states:

> "It is by no means clear from the record that any of the assets, in fact, belong to the father."

The record, however, is quite clear that the assets did belong to the father. When the partnership between Petitioners and his father was first entered into (Exhibit 9 executed in 1950), Petitioner's father purchased a one-half interest in the machines (R. 61 and 62). The uncontroverted evidence shows that Petitioner's father prior to the formation of Spiesman & Sons owned the machines equally (Transcript 81, 82). The Respondent apparently confuses the two partnership agreements (Exhibits 9 and 10). It is the first partnership agreement (Exhibit 9) which shows uncontroverted that Petitioner's father owned an interest in the machines. Again, the Respondent has misconstrued Petitioners' argument and has failed to set forth any reason why the Tax Court should not be reversed under Assignment of Error IV, referred to above.

## CONCLUSION

Petitioners in their main brief have illustrated the incorrectness of the Tax Court's decision here under review. The Respondent's main brief does nothing to disturb the reasoning behind Petitioners' arguments. The Tax Court of the United States has erred in failing to recognize the validity of the family partnership here involved.

Petitioner, his five sons and his father formed a family partnership. The partnership was valid in every respect. The proportionate share of the partnership profits during the years were set aside for the children and were not used for the maintenance and support of the children. None of the money allocated to the children was ever used by the Petitioner. The record shows that the money is still on deposit in the children's names. The partnership was no sham and the gifts to the children were valid in every respect. The decision of the Tax Court should therefore be reversed.

Respectfully submitted,

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